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Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 415

UNITED STATES OF AMERICA, *Petitioner,*

v.

WATERMAN, LARGEN & CO., INC., *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Claims

BRIEF FOR THE RESPONDENT IN OPPOSITION

JOSEPH E. MCANDREWS
CAROL K. NICKEL
IVINS, PHILLIPS & BARKER
1700 Pennsylvania Ave., N. W.
Washington, D. C. 20006
Attorneys for Respondent

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW AND JURISDICTION

The opinions below and the basis of this Court's jurisdiction are adequately set forth in the petition.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 162. TRADE OR BUSINESS EXPENSES.

(a). IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses

paid or incurred during the taxable year in carrying on any trade or business, including . . .

Sec. 165. Losses.

(a) GENERAL RULE. There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

QUESTION PRESENTED

Whether a loss realized on the sale of stock of a yarn mill purchased and held by a yarn mill broker solely to retain an existing commission account, is an ordinary loss or business expense rather than a capital loss where the stock purchase was a business necessity in order for the broker to continue to exist in its then corporate form.

STATEMENT

Respondent is in the business of selling, on a commission basis, various types of yarn produced by its mill accounts, one account of which was the Elmvale Worsted Company, hereinafter called Elmvale, a Massachusetts corporation located in Pittsfield, Massachusetts. (Pet. App. A51-52)

Elmvale, by the latter part of 1958, had become Respondent's third largest account and the principal factor in the worsted division of its business. Elmvale, however, had found operations unprofitable and in early December, 1958, it decided to terminate operations. (Pet. App. A54-55)

The potential loss of this account was a serious blow to Respondent. Respondent was then operating at

a loss and the Elmvale account was an important segment of its worsted sales operation and was the only substantial worsted wool account Respondent had. (Pet. App. A55-56)

Respondent promptly and diligently attempted to obtain another worsted wool account but did not succeed, since such accounts were extremely difficult to secure. Respondent, knowing that Elmvale's president wished to insure his son's business future, inquired whether he would be interested in continuing in business if some other satisfactory mill could be located at a different location. When he replied that such a possibility would be given every consideration, Respondent went out and located a suitable mill in Laurens, South Carolina. (Pet. App. A55-56)

After investigating and inspecting this new plant site, Elmvale's president disclosed his willingness to become the dominant shareholder in a new corporation to be organized to take over the assets of the Laurens plant. (Pet. App. A57)

Some meetings were held to discuss the possibilities of reopening in South Carolina and at one of these meetings Respondent's role in connection with the new organization was discussed. Elmvale's president stated that Respondent would not be permitted to act as Elmvale's commission agent unless Respondent purchased $100,000 worth of stock that would be issued in connection with the setting up of the new corporation. For such $100,000 participation, however, it would become the exclusive selling agent for the Laurens operation. (Pet. App. A57-58)

In view of the impossibility of securing another worsted wool account, Respondent's officers determined

that they would either have to attempt to secure the Laurens account or to liquidate or otherwise drastically reorganize their business. They finally concluded that Respondent should, in an effort to continue as a business entity in its then form, attempt to raise $100,000 in order to obtain the Laurens account. (Pet. App. A58-59)

After arranging to borrow the necessary funds, Respondent's officers advised the Elmvale president that they would be willing to put $100,000 in the proposed corporation, provided they would be designated as its exclusive selling agency (Pet. App. A59-60)

Further details were worked out and a final agreement was reached in May, 1959. (Pet. App. A60)

Respondent did not put the $100,000 into Elmvale as an investment in the sense of looking to future stock appreciation or dividends as a return on capital. The sole purpose of borrowing the money and putting it into the stock of Elmvale was to regain an important selling agency arrangement and therefore replace the commissions lost from the (old Massachusetts) Elmvale corporation. It was anticipated that the expected commissions would result in the profitable operation of Waterman, Largen's worsted wool division and would permit repayment of the loan within two or three years (Pet. App. A58-59, 61-62)

Respondent received $51,900 in commissions from Elmvale between May, 1959, and June, 1961. (Pet. App. A62-64)

Elmvale's operations continued to be unprofitable even in the new location, however, and by May of 1961, an Elmvale financier required Elmvale to appoint

a competitor of Respondent as sales agent, thereby discontinuing Respondent as exclusive sales agent. On June 22, 1961, Respondent's sales agency with Elmvale was completely terminated effective June 30, 1961. (Pet. App. A63-64)

Since the only business reason for retaining the stock interest in Elmvale was thus terminated, Respondent immediately took steps to sell the stock. On July 21, 1961, Respondent sold its shares for $25,000, resulting in a loss of $75,000. (Pet. App. A65)

ARGUMENT

The taxpayer, Waterman, Largen & Co., Inc., opposes the Petition for Writ of Certiorari in this case because there is no conflict among the Courts of Appeals or the Court of Claims on the issue presented and certainly no question of substantial legal importance which has not previously been resolved by this Court.

1. The issue in this case is whether a loss on the sale of stock purchased to acquire or insure a source of everyday business requirements (in this case sales commissions obtained through an exclusive sales contract) is an ordinary loss or a capital loss. This issue is governed by the principle set forth in the decision of this Court in *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955). That principle can be stated to be that, even though the literal language of the definition of a capital asset[1] may be met, Congress intended that profits and losses arising from the everyday operation of a business should be considered as

[1] Section 1221, Internal Revenue Code of 1954.

ordinary income or loss rather than capital gain or loss. It would appear that this principle directly contradicts the contention made in the Petition (pp. 8-9) that the language "(whether or not connected with his trade or business)" in the definition of a capital asset requires capital loss treatment.

During the fifteen years since the *Corn Products*, *supra*, decision, this specific issue has come before the Tax Court,[2] a number of District Courts,[3] four U.S. Courts of Appeals,[4] and the Court of Claims.[5] No conflict has developed. The lower court decisions have applied the principle announced in *Corn Products*, *supra*, to a myriad of factual situations with no greater difficulty than is encountered in the normal judicial process of applying governing legal principles to a variety of factual situations. In addition, the cases have not been uniformly favorable to the taxpayer. The Government has succeeded in denying ordinary

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[2] See, *e.g.*, *Western Wine & Liquor Co.* v. *Commissioner*, 18 T.C. 1090, acq. 1958-2 C.B. 8; *Electrical Fittings Corp.* v. *Commissioner*, 33 T.C. 1026; *Livesley* v. *Commissioner*, 19 T.C.M. 133; *Old Dominion Plywood Corp.* v. *Commissioner*, 25 T.C.M. 678; *Southeastern Aviation Underwriters, Inc.* v. *Commissioner*, 25 T.C.M. 412.

[3] See, *e.g.*, *Journal Co.* v. *United States*, 195 F. Supp. 434; *Hogg* v. *Allen*, 105 F. Supp. 12; *Hagan* v. *United States*, 221 F. Supp. 248.

[4] *Commissioner* v. *Bagley & Sewall Co.*, 221 F.2d 944 (2d Cir.); *Edwards* v. *Hogg*, 214 F.2d 640 (5th Cir.); *Grier, John J., Co.* v. *United States*, 328 F.2d 163 (7th Cir.); *Steadman* v. *Commissioner*, 424 F.2d 1 (6th Cir.).

[5] *Booth Newspapers, Inc.* v. *United States*, 157 Ct. Cl. 886, 303 F.2d 916; *F. S. Services, Inc.* v. *United States*, 188 Ct. Cl. 874, 413 F.2d 548.

loss treatment[6] and in imposing ordinary income treatment[7] under the *Corn Products* principle.

Given the governing principle set forth in *Corn Products, supra*, as well as in *Hort* v. *Commissioner*, 313 U.S. 28, and *Commissioner of Internal Revenue* v. *P. G. Lake, Inc.*, 356 U.S. 260, limiting the definition of a capital asset to exclude items which are essentially an element of ordinary income, the application of this principle to the numerous factual situations in which the issue arises must necessarily be left to the trier of fact. The issue is essentially a factual issue.[8] As this Court stated in *Corn Products, supra*, at page 51:

> "For tax purposes Petitioner's purchases have been found to 'constitute an integral part of its manufacturing business' by both the Tax Court and the Court of Appeals, and *on essentially factual questions* the findings of two courts should not ordinarily be disturbed." [Emphasis added].

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[6] See *Gulftex Drug Co.* v. *Commissioner*, 29 T.C. 118, aff'd *per curiam* 261 F.2d 238; *Missisquoi Corp.* v. *Commissioner*, 37 T.C. 791; *Chase Candy Co.* v. *United States*, 130 Ct. Cl. 102, 126 F. Supp. 521; *Duffey* v. *Lethert*, 63-1 U.S.T.C. ¶ 9442.

[7] See, *e.g.*, *Mansfield Journal Co.* v. *Commissioner*, 274 F.2d 284; *Pierce, S.S., Co.* v. *United States*, 57-2 U.S.T.C. ¶ 9886; *Hollywood Baseball Association* v. *Commissioner*, 423 F.2d 494 (9th Cir. 1970), cert. applied for May 14, 1970.

[8] Here, the facts show that the taxpayer was a commission sales agent of yarn. The Court of Claims found that the sole purpose of purchasing the stock in question was to regain an important yarn sales agency arrangement it would otherwise have lost. The taxpayer succeeded in regaining the agency arrangement and earned $51,900 in commissions during the two-year period the arrangement endured. After the arrangement was terminated, the taxpayer sold the stock it was required to purchase to obtain the sales agency agreement. It incurred a loss of $75,000 on such sale.

The Opinion of the Commissioner of the Court of Claims, adopted by the Court below, found (Pet. App. A33) that:

> "It seems plain that the situation falls within the *Booth Newspapers* principle as '*securities . . . purchased by a taxpayer as an integral and necessary act in the conduct of his business*' . . ." [Emphasis added]

Thus, on the *essentially factual question*, we have the same finding here by both the Commissioner and the Court of Claims as was true in *Corn Products, supra*. Given such findings and this Court's statement in similar circumstances that such findings should not ordinarily be disturbed, grant of the instant Petition would appear to be fruitless.

2. It could be argued that the *Corn Products, supra*, principle is inapplicable to the instant case because *Corn Products, supra*, involved regular purchases and sales, rather than a single transaction. However, the application of the *Corn Products, supra*, principle to a "one shot" purchase of capital stock of a corporation is recognized and accepted by the Petitioner in its Petition (pp. 12-14) as well as by the acquiescence of the Internal Revenue Service in *Western Wine and Liquor, supra* fn. 2, and in Rev. Rul. 58-40, 1958-1 C.B. 275. Further, the Petition does not quarrel with the so-called step-transaction doctrine that if one asset is acquired solely to obtain another, it is deemed that the latter asset has been acquired to determine the tax consequences of the transaction. Thus, in applying this doctrine to the instant case, the character of the tax treatment of the $75,000 loss incurred by the taxpayer turns on the question whether a commission sell-

ing agent can deduct as an ordinary loss the amount paid to obtain an agency contract when that contract is subsequently cancelled. The law is clear that an ordinary loss is to be allowed.[9] On the other hand, had the taxpayer not only earned the commissions but also realized a profit on the sale of the agency contract itself, capital gain would not be allowed on the contract.[10]

The Petition in this case does not ask this Court to overrule the principle set forth in *Corn Products*, *supra*, or to reject the "step transaction" or "look through" doctrine relied upon in *Western Wine and Liquor*, *supra*. Rather, this Court is apparently asked to lay down further rules as to when the *Corn Products*, *supra*, doctrine should be applied. It is submitted that this issue of capital gain or loss arises in a wide variety of differing factual situations which do not lend themselves to detailed rules. The business exigencies which may cause a taxpayer to purchase one asset in order to obtain another asset which is vital or necessary to his everyday business operations do not come in simple, neat, factual packages for which a set of specific rules is appropriate. It is submitted that the governing principles of *Corn Products*, *supra*, and *Western Wine and Liquor*, *supra*, are the proper

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[9] See, *e.g.*, *Robert Templin*, 13 T.C.M. 757 (auto franchise); *Elston Co.* v. *U.S.*, 21 F. Supp. 267 (Ct. Cls. 1937) (liquor license); *Metropolitan Laundry Co.* v. *U.S.*, 100 F. Supp. 803 (customer list); *Meredith Broadcasting Co.* v. *U.S.*, 405 F.2d 1214 (Ct. Cls. 1969) (TV network affiliation contract); Rev. Rul. 57-503, 1957-2 C.B. 139 (goodwill).

[10] See not only *Corn Products*, *supra*, but also *Leonard Hunter* v. *Commissioner*, T.C. Memo 1961-318, aff'd 325 F.2d 715 (5th Cir.), cert. den. 379 U.S. 832; *Maryland Coal & Coke Company* v. *McGinnis*, 350 F.2d 293 (3rd Cir. 1965).

guidelines to be applied by the lower courts. The fact that 15 years after the *Corn Products*, *supra*, decision no conflict among the lower courts has arisen demonstrates this. The three cases presently before this Court on Petitions for Writ of Certiorari[11] all reflect consistent application of the governing principle of *Corn Products*, *supra*, to different factual situations. Rules or restrictions which might be adopted to limit the application of the *Corn Products*, *supra*, principle to a given set of facts will almost certainly give rise to additional problems and further litigation with respect to a different set of facts.

A consistent body of law exists with respect to each aspect of the Government's purported distinctions between *Corn Products*, *supra*, and the instant case, namely, that *Corn Products*, *supra*, involved inventory rather than other assets,[12] that *Corn Products*, *supra*, involved transactions for a temporary period,[13] and that *Corn Products*, *supra*, involved a continuing series of transactions.[14] Any alleged conflict in the decisions is factual, rather than legal, and results from

[11] *Steadman* v. *Commissioner*, *supra* fn. 4; *Hollywood Baseball Association* v. *Commissioner*, *supra* fn. 7; and the instant proceeding.

[12] See *Commissioner* v. *Gillette Motor Transport, Inc.*, 364 U.S. 130; *Hort* v. *Commissioner*, 313 U.S. 28; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260 for denial of capital gain on disposition of noninventory assets.

[13] See *Corn Products*, *supra*, where the taxpayer had a regular practice of purchasing futures to insure a supply of manufacturing requirements and fn. 5 at p. 49 for a five-year history of this practice.

[14] See *Western Wine and Liquor*, *supra*, fn. 2, and Rev. Rul. 58-40 for application of the *Corn Products*, *supra*, principle to a single transaction.

application of consistent legal standards to varying factual situations.[15]

The legal standards applied in these decisions which apply the *Corn Products*, *supra*, principle to the sale or worthlessness of stock are not only consistently applied, they are also virtually identical to the standards applied to determine whether a taxpayer has suffered a "business" bad debt, which is deductible in full in the year of worthlessness under section 166 (a) of the Internal Revenue Code of 1954, or a "nonbusiness" bad debt, which is deductible as a short-term capital loss under section 166(d).[16]

3. If there is any issue of great importance, it would not appear to be a conflict in the lower court decisions but the Government's auditing problem referred to in the Petition (pp. 19-21). Simply put, the Government says a gain on the sale of stock will always be reported as capital gain and, if appropriate, a loss will be reported as an ordinary loss. Apparently, the problem arises because stock is presumed to be a capital asset. However, the taxpayer does not see how

[15] It is analogous to the application of this Court's decisions in *John Kelley Co.* v. *Commissioner*, 326 U.S. 521; *The Donruss Co.* v. *United States*, 393 U.S. 297; or *Malat* v. *Riddell*, 383 U.S. 569, to the numerous factual situations involving, respectively, the question of whether a loan to a corporation should be treated as a valid debt or a contribution to capital, whether a business is unreasonably accumulating its income or whether a particular asset is sold in the ordinary course of trade or business. Certainly the Petitioner would not ask the Court to reexamine its decisions in those cases in light of their application to varied factual situations, yet it is asking for such a reexamination in the instant case.

[16] See *Whipple* v. *Commissioner*, 373 U.S. 193 (1963); *Niblock* v. *Commissioner*, 417 F.2d 1185 (7th Cir. 1969); *Estate of Saperstein*, T.C. Memo 1970-209.

the Government has asked this Court to solve its auditing problem. The Government concedes that under some circumstances a loss incurred on a one-shot sale of stock is entitled to be treated as an ordinary loss. See, *e.g.*, Pet. 12-14, *Western Wine and Liquor*, *supra*, and the Government's acquiescence therein, *supra* fn. 2; Rev. Rul. 58-40, *supra*. However, if in these situations the stock in question had appreciated in value during the period held, the Government would have had exactly the same auditing problem described in the Petition if the taxpayer there had reported the profit as a capital gain. Consequently, the taxpayer fails to see how the auditing problem is a relevant factor before this Court. If there is such an auditing problem, it would appear that if the Internal Revenue Service cannot provide adequate safeguards as they have with respect to entertainment expenses and numerous other subjects [17] and as is proposed on the 1970 return with respect to disclosure of foreign bank accounts,[18] Congress would be the appropriate branch of the Government in which to seek relief.[19]

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[17] See, *e.g.*, Questions G through Q on Corporate Return Form 1120.

[18] See Commissioner of Internal Revenue Thrower's announcement, May 11, 1970. In addition, the Internal Revenue Service does not appear to encounter any auditing difficulties in applying section 265 to disallow deductions incurred to purchase or carry tax-exempt bonds, even though the interest earned on such bonds is not reported by individuals in any way.

[19] In this connection, it might be noted that at no point in the entire legislative history of the recently-enacted Tax Reform Act (primarily enacted to close "loopholes") is there any mention of the "loophole" complained of in the Petition.

CONCLUSION

The Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

JOSEPH E. MCANDREWS
CAROL K. NICKEL
Attorneys for Respondent

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REPLY BRIEF FOR THE UNITED STATES AND THE COMMISSIONER

ERWIN N. GRISWOLD,
Solicitor General,
JOHNNIE M. WALTERS,
Assistant Attorney General,
MATTHEW J. ZINN,
Assistant to the Solicitor General,
THOMAS L. STAPLETON,
JANET R. SPRAGUE,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

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REPLY BRIEF FOR THE UNITED STATES AND THE COMMISSIONER

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1. The briefs in opposition in these cases themselves demonstrate the need for prompt review and correction by this Court.

Respondents concede (Br. (No. 415) 8; Br. (No. 416) 10) that they acquired capital interests in corporations; Waterman, Largen concedes (Br. (No.

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